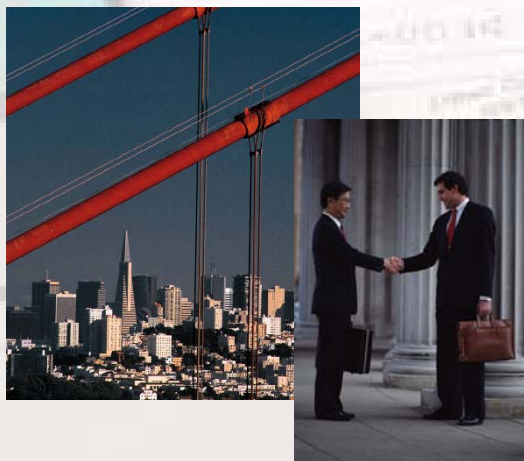


Bankers' Compliance Group
17th Annual Bank Management and
Directors Seminar
December 5, 2002 - Santa Clara, CA

“What Do Examiners Expect from Boards of Directors”



Presentation by Donald R. Meyer
Commissioner of Financial Institutions
State of California

STATE OF CALIFORNIA
BUSINESS, TRANSPORTATION & HOUSING AGENCY



Department of Financial Institutions
"Safety and Soundness"

- **Mission:** The DFI is responsible for regulating the safety and soundness of state-chartered financial institutions, to maintain public confidence and facilitate a strong financial services system.
- **Vision:** To develop business systems which meet the changing needs of our institutions, our employees, and the public.



DFI's annual budget is \$20,095,000

Financial Institutions Fund \$16,618,000

Local Agency Deposit Fund \$306,000

Credit Unions Fund \$3,171,000

We supervise approximately 700 (including 187 banks, 218 credit unions) financial institutions.

The assets of these institutions total over \$214 billion.

Almost 70 percent of our Department's 225 full-time employees are financial institution examiners.

DFI reports to Secretary Maria Contreras-Sweet, Business, Transportation and Housing Agency and Governor Gray Davis.

Financial Institution Overview— 2000 to 9/30/02

I. Number of Institutions

Commercial banks	2000	2001	9/30/02
State-chartered banks at yearend	202	196	187
De novo state banks opened during the year	5	8	4
Conversions to state banks during the year	-	1	1
National banks at yearend	82	84	81
De novo national banks opened during the year	3	8	2
Conversions to national banks at yearend	1	-	-
Credit unions			
State-chartered credit unions at yearend	215	218	221
Conversions to state charter	13	7	5
Federal credit unions at yearend	436	418	394
Conversions to federal charter	-	-	-
Industrial banks			
Industrial banks at yearend	22	21	20
New industrial banks opened	-	-	-
Trust companies			
Trust companies at yearend	20	14	13
New trust companies opened	-	-	-

I. Number of Institutions - continued

Savings and loan associations			
Savings and loan associations at yearend	4	1	1
New savings and loan associations opened	-	-	-
Foreign (other nation) bank agencies/branches			
Foreign banks with state agencies/branches at yearend	54	49	43
New agencies/branches opened	1	-	1
Foreign banks with federal agencies/branches	8	8	7
New agencies/branches opened	-	-	-
Foreign (other nation) bank representative offices			
Foreign banks with representative offices at yearend	23	20	17
New representative offices opened	6	-	1
Foreign (other state) bank facilities offices			
Foreign (other state) banks with facilities at yearend	42	36	33
New facility offices opened	1	3	3

I. Number of Institutions - continued

Premium finance companies			
Premium finance companies at yearend	72	68	68
New premium finance companies opened	2	3	6
Transmitters of money abroad	2000	2001	9/30/02
Transmitters of money abroad at yearend	53	55	55
New transmitters of money abroad opened	5	3	3
Issuers of payment instruments			
Issuers of payment instruments at yearend	11	10	10
New issuers of payment instruments opened	1	-	-
Issuers of travelers checks			
Travelers check issuers at yearend	6	5	5
New issuer of travelers checks opened	-	-	-
Business and Industrial Development Corporations (BIDCOs)			
BIDCOs	1	2	2
New BIDCOs opened during the year	1	1	-

November 26, 2002

Financial Institution Overview— 2000-2002

II. Total Assets (in millions of dollars)

Type of Institution	12/31/00	12/31/01	9/30/02
<i>Commercial banks</i>			
State-chartered banks	\$124,053.6	\$134,521.9	\$142,862.8
National banks	173,492.1	214,228.7	246,352.5
<i>Credit unions</i>			
State-chartered credit unions	35,812.8	43,740.2	48,811.9
Federal credit unions	30,266.1	33,264.4	35,989.7
<i>Industrial banks</i>	10,934.1	11,529.2	11,841.2
<i>Savings and loan associations</i>	2,161.1	305.6	327.1
<i>Foreign Banks</i>			
State-chartered agencies and branches of foreign banks	25,528.7	19,669.1	16,269.6
Federal agencies and branches of foreign banks	953.7	NA	NA
<i>Trust companies</i>	632.2	651.6	551.3
<i>Premium finance companies</i>	215.8	298.3	NA

DFI Web Site

- 2001 DFI Annual Report
- Financial Statistics
- Monthly Bulletins/Weekly Bulletins

www.dfi.ca.gov

Recent Accomplishments

- Developed an integrated “early warning system” and examination scheduling tool nicknamed “HORUS”
- Accreditation from the Conference of State Bank Supervisors (CSBS); and from the National Association of State Credit Union Supervisors (NASCUS)
- Governor Proclaimed April “California Financial Literacy Month”
- Three new consumer education publications: Consumer Assistance for Customers of State Financial Institutions (Who Regulates My Financial Institution?), Tips for Financial Transactions, and Transmitting Money Abroad (available in Spanish) -- all available in print and on the DFI Web site.



The Question:

What Do Examiners Expect From Boards of Directors?

10
critical
management
areas

1. Audit Function, Internal Controls

■ Adequate audit program

- ◆ In written form
- ◆ Approved by board of directors or audit committee
- ◆ Reviewed on a regular basis
- ◆ Revised when necessary

Audit function, internal controls (continued)

- Adopting, implementing and enforcing a system of internal control audits to
 - ◆ Safeguard assets
 - ◆ Ensure accuracy and reliability of data
 - ◆ Ensure compliance with bank policies and applicable laws and regulations
 - ◆ Promote management efficiency

Sarbanes-Oxley

- The OCC, FDIC and FRB have said that corporate governance will be their chief supervisory concern.
- Banks should adopt the provisions of the act as best practices.

Best Practices for Board Members

- **Review the provisions of the Sarbanes-Oxley Act.** They provide the foundation for change. Your attorney, consultant or accountant have information about them.
- **Ensure the audit committee is reviewing internal and external audit issues.** Financial literacy is essential for audit committees. Large or complex institutions may find it necessary to create audit subcommittees for specific activities.

Best Practices continued

- **Actively oversee risk management.** Risk management oversight should be an official duty of an existing board committee or perhaps a new one.
- **Be prepared to ask the tough questions.** Directors need to be better informed and understand what constitutes a red flag.
- **Separate the chief executive and chairman roles, or appoint a lead director.** Allows directors the opportunity to discuss issues without management present, and lead directors are important for facilitating these discussions.

Best Practices continued

- **Set high ethical standards.** Board members demonstrate through their own actions and the bank's official code of conduct that the organization is committed to maintaining sound ethical principles.
- **Make your board one that directors are proud to serve on.** By following best practices in governance, your board can attract and retain good directors.

2. Management oversight, relationship between board and management

- Primary duty to select and appoint executive officers
- Responsible for supervising the bank's affairs
 - ◆ Insisting board policies are being implemented and adhered to by management

3. Risk assessment and management

- Board oversight is vital to effective risk management
 - ◆ Board of directors should adopt policies that establish guidelines for management and periodically review performance

Risk assessment and management (Continued)

- Examiners will assess management's ability to manage, monitor and control risks by
 - ◆ Reviewing lending policies, credit underwriting and the loan review process
 - ◆ Analyzing the adequacy of loan loss reserve methodology
 - ◆ Reviewing investment portfolio guidelines and asset /liability management practices
 - ◆ Assessing the board and management's ability to respond to changes in business conditions or the initiation of new activities and products

4. Regulatory compliance

- It is expected that banks comply with all laws and regulations applicable to them
 - ◆ High priority is assigned to the detection and prompt correction of violations of laws and regulations
 - ◆ Policies and procedures are expected to be developed, implemented and effectively communicated

5. The examination process

- We encourage full communication between examiners, management and the board of directors
 - ◆ Boards of directors are expected to thoroughly review the report
 - ◆ Respond to report findings and recommendations
 - ◆ Document review and response in the minutes of board meetings

6. Safety and Soundness

- Sound management practices are demonstrated by active oversight by the board, competent personnel, adequate policies, processes and controls

To determine a bank's condition, DFI examiners evaluate:

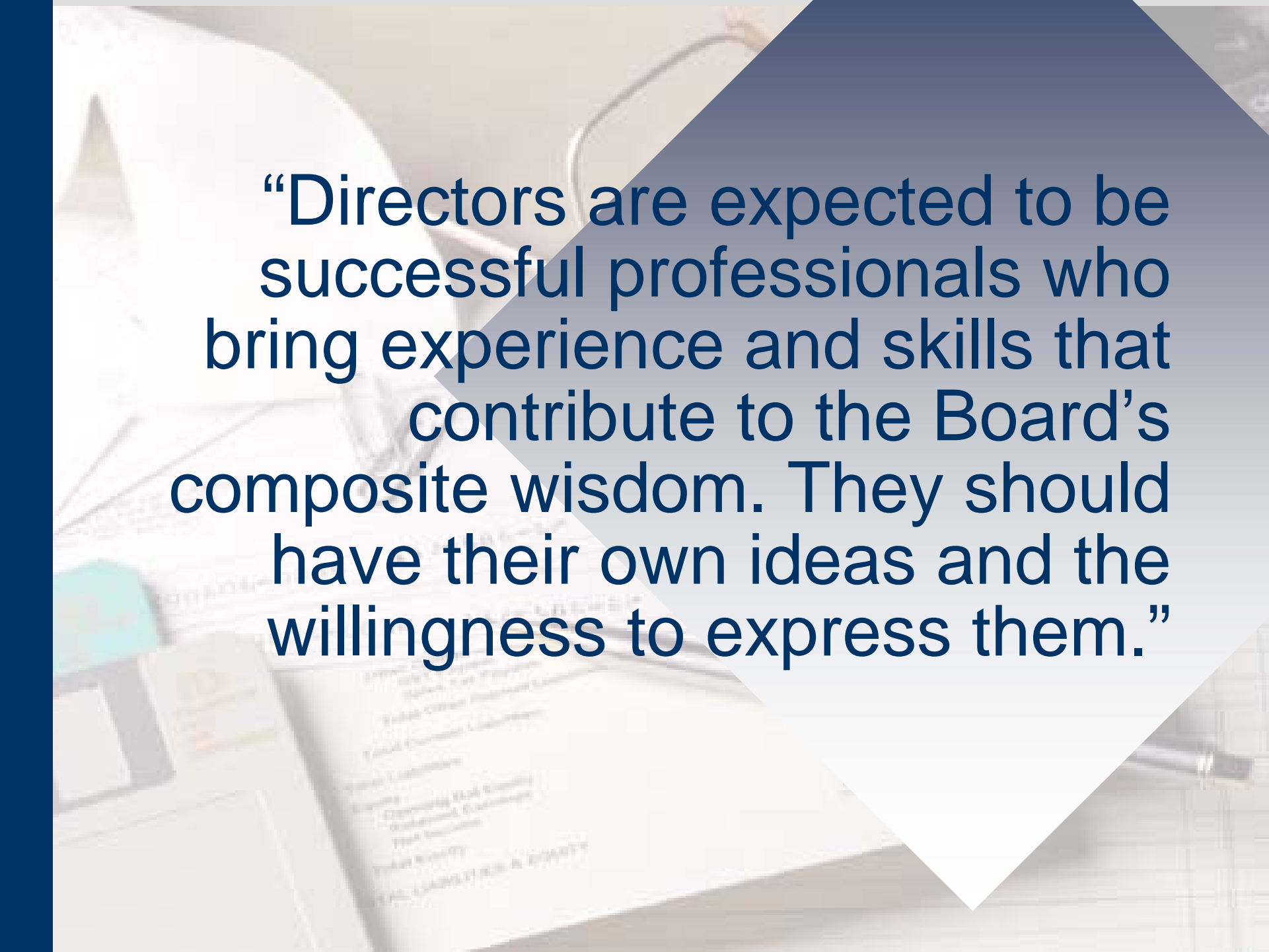
- ◆ the size and sophistication of the institution
- ◆ the maintenance of an appropriate audit program and internal control environment, and
- ◆ effective risk monitoring and management information systems

7. Bank performance

- The board's policies should have established mechanisms for providing the information needed to monitor the bank's performance
 - ◆ generating an adequate return to share holders, while protecting the interests of depositors and creditors
- Directors must be able to discern poor operating performance using well designed management reports

8. Strategic planning

- Sound strategic planning is a must in dealing with the environment that innovation and increased competition have produced
 - ◆ Should be an ongoing process from which a mission and objectives are developed
 - ◆ Road map of the vision of the board
 - ◆ Sets reasonable and measurable goals and assign responsibility for attaining these goals

The background of the slide is a blurred photograph of a desk. On the left, a portion of a white calculator is visible. In the center, a silver pen lies horizontally. Below the pen, there is a document with some text and a small blue tab. The right side of the slide is partially covered by a dark blue triangular graphic element.

“Directors are expected to be successful professionals who bring experience and skills that contribute to the Board’s composite wisdom. They should have their own ideas and the willingness to express them.”

9. Directors' qualifications/stock ownership

- Should not be unduly influenced by another director or by bank management
- Should be familiar with the local community and the bank's trade area
- Directors should be able to bring quality business to the bank
- A director should have high personal integrity and be capable of recognizing and avoiding conflicts of interest

10. Business development

- Directors should take an active interest in the bank's affairs by promoting the bank through business and personal contacts
- Watch for opportunities for the bank to gain new business

Useful Publications for Directors

- 1) *Basics for Bank Directors*, Third Edition, Forest E. Myers, Division of Supervision and Risk Management, Federal Reserve Bank of Kansas City.

Available in electronic form on the Federal Reserve Bank of Kansas City website at <http://www.kc.frb.org>.

- 2) *Financial Institution Directors' Liabilities & Responsibilities*, Fifth Edition, Dr. Douglas V. Austin and Jeffery E. Smith.

Available from Austin Financial Services at 419-531-9559.

Useful Publications for Directors (Cont.)

- 3) *The Director's Book - The Role of a National Bank Director*, Office of the Comptroller of the Currency.

Available on the OCC website at
<http://www.occ.treas.gov/index.htm>.

- 4) *Red Flags in Board Reports - A Guide for Directors*, Office of the Comptroller of the Currency.

Available on the OCC website at
<http://www.occ.treas.gov/index.htm>.

Useful Publications for Directors (Cont.)

- 5) *Internal Controls - A Guide for Directors*, Office of the Comptroller of the Currency.

Available on the OCC website at
<http://www.occ.treas.gov/index.htm>.

- 6) *Executive Officer and Director Compensation Survey*, California Department of Financial Institutions.

Available on the DFI website at
<http://www.dfi.ca.gov/Press&Pub.htm>.

Contact Information

www.dfi.ca.gov

111 Pine Street, Suite 1100
San Francisco, CA 94111-5613
(415) 263-8500

1810 13th Street
Sacramento, CA 95814
(916) 322-5966

300 S. Spring Street, Suite 15513
Los Angeles, CA 90013-1204
(213) 897-2085

9609 Waples Street, Suite 100
San Diego, CA 92121
(858) 642-4242